Jeremy Hunt’s smooth(ing) Budget

15 February 2023
Torsten Bell

A month today Jeremy Hunt will deliver his first Budget. It’s shaping up to be a calmer affair than last Autumn’s repeated emergency fiscal announcements. Then again almost anything would.

That air of normality extends to plans to use the Budget to focus on longer-term questions, specifically how to get more people working and the economy growing. But planning a more ‘normal’ Budget, doesn’t mean anything about the current economic situation is normal.

Whatever Westminster wants to talk about, the cost-of-living crisis is the backdrop to this Budget, and is where families are focused. So, despite headlines saying “Energy bills extra support ruled out by chancellor”, the Chancellor will have more to say on the topic. Here’s why, and what that is likely to be.

The big energy news of recent months is good news: European wholesale gas prices for 2023-24 are down 75 per cent since from their summer peak, and 50 per cent since the Chancellor’s Autumn Statement. This is incredibly welcome – reducing the risk, or at least depth, of a 2023 recession.

But it creates a challenge when combined with the timing of Treasury measures to reduce energy support: a rollercoaster for household bills, rising from the equivalent of an annualised £2,500 for a typical bill today to £3,000 in April, before falling back to a little below £2,400 from July.
Figure 1  Wholesale prices have fallen dramatically but energy bills are set to rise

Wholesale gas futures prices (left chart) and annualised energy bill forecasts (right chart): UK/GB

Notes: Average prices show gas price forward delivery contracts, weekly average, GB. Typical annualised energy bill. Source: RF analysis of ICE Futures Europe; Ofgem price cap methodology, Government Energy Price Guarantee, Cornwall Insight.

The best way of thinking about what is driving this is that the government limit on energy bills (the Energy Price Guarantee or EPG) is rising earlier than wholesale market price falls feed through into lower prices for consumers (via Ofgem’s energy price cap) – remember whichever is lower of these two determines the actual costs facing consumers as our next chart shows.

Figure 2  The Energy Price Guarantee is rising before price falls feed through

Typical annual energy bill under EPG and Ofgem price cap: GB

Source: RF analysis of Cornwall Insight; Ofgem.
This rollercoaster makes little sense. The point of government policy during this crisis has been to smooth consumers through the worst of the energy price shock (the case for which is strengthened by the fact that we have now learnt that much of the increase is likely to be temporary). But now policy isn’t smoothing prices, it’s causing the spike.

For customers who pay their bills by direct debits, their payment method will smooth out payments even if policy makers fail to smooth out energy costs this spring. But the most acute problem is for those on pre-payment meters (PPM), whose payments are not smoothed at all and will have to find almost £250 in cash for April’s bill alone.

In fact, the bill increases in April will be even starker as the £400 universal payments (the Energy Bills Discount) also come to an end then. Even as temperatures rise and energy usage falls, this means typical PPM customer monthly bills are on course to rise by 22 per cent from March to April (from £202 to £247).

The solution is pretty obvious. The Treasury can – and almost certainly will – delay the increase in EPG for three months to give wholesale prices time to feed through.

This will have a price tag, increasing the cost of the EPG next year from £1.5 billion to £4.5 billion.1 A £3 billion increase is significant, but still leaves more significant savings compared to the expected cost of £12.8 billion at the time of the Autumn Statement. Put it this way: falling wholesale prices knocked 90 per cent off the estimated cost of the EPG next year. Even if the Chancellor chooses to iron this temporary bill rise out, the cost of the EPG in 2023-24 will still have fallen by around two-thirds (65 per cent) since last November.

The Treasury will be content to live with this because the cost is clearly temporary, with no impact on their central fiscal rule to have “debt falling in the medium term” or their ongoing exposure to wholesale gas price movements.

The Bank of England will be actively keen too, with the coming spike in energy bills in April at risk of slowing the pace of inflation falls this year. Smoothing the spike out will bring inflation down by 1 percentage point in April from where it would otherwise be, as the next chart shows. This would accelerate current falls in inflation (even though it won’t change inflation’s underlying trajectory, and will have an offsetting temporary upward pressure on inflation in the second quarter of 2024). Based on the Bank of England’s inflation forecast, inflation in the second quarter of 2023 would be 7.5 per cent without the energy cost spike, compared to 8.4 per cent on current plans.
While the Bank is largely (and rightly) focused on the prospect of domestically generated inflation, some see early and material inflation falls this year as important for keeping inflation expectations anchored. And with the Chancellor and Prime Minister focusing on cutting inflation as their immediate objective, it’s not just central bankers who want the trend of falling inflation to accelerate through the spring.

Finally, returning to what this means for consumers, we should be clear about what this approach will, and will not achieve. Even with removing the spring energy cost spike, a typical household bill in 2023-24 will be £500 higher than in 2022-23 and £1,300 above their pre-crisis norms (2019-20). Without further wholesale price falls we will still feel far poorer than we are used to. But a Budget that removed the spike would make a real difference to the cash flow of many low- and middle-income households on PPMs by removing this policy driven rollercoaster for energy prices.

The Chancellor rightly wants a calmer, smoother Budget in March, while households – particularly those on lower incomes – need smooth energy costs. On both counts it doesn’t make sense for the government to put energy bills on a rollercoaster this spring. So how about we don’t?

1 Based on the latest Cornwall Insight’s forecast that typical retail prices without the EPG would be £3,338 for the first quarter of 2023-24.